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LOCAL GOVERNMENT IN JAPAN: NATIONAL AND INTERNATIONAL ASPECTS

Summary

As economic relations between the United States and Japan have become more complicated, negotiators on both sides of the Pacific increasingly have focused on policies and practices in the other country that fall under the heading of domestic or even local. For example, a number of the barriers Washington cited during the Structural Impediments Initiative talks -- high land prices, a complex distribution system and administrative guidance -- result at least in part from local government actions. Furthermore, American firms, backed by U.S. negotiators, are pushing for changes in the government procurement process at both the national and the local level. In various ways, therefore, local government policies and practices have an international impact.

In Japan local autonomy is limited. Although three-fourths of total public-sector expenditures are undertaken by local governments, prefectural and municipal tax revenues cover barely 40 percent of their expenditures. Tokyo supplies most of the remaining funds. That gives central government officials a major say in the shape of many local programs. It also forces prefectural and municipal authorities to consult frequently with the central government and to stay on good terms with officials in Tokyo if they want to get a bigger share of the pie for their area.

Ongoing reviews of the relationship between the central and local governments by public-sector advisory panels and several private-sector groups have looked at how to balance economic development across Japan and strengthen the autonomy of local authorities. These reviews have examined the possibility of transferring some regulatory authority from Tokyo to local entities,

changing the central government's revenue-sharing formula, reshuffling existing local administrative units plus relocating the national capital. Implementation of these administrative reforms could contribute to resolving a number of the structural problems cited by Washington at the SII talks and eventually could provide more business opportunities for foreign companies in Japan.

Local Government and Its History in Japan

A two-layered local government system came into being during the late 1870s and the 1880s when the Meiji government introduced Western-style political institutions based on the first constitution in Asia. At the most basic level are 656 shi (cities), 1,998 machi (towns) and 585 mura (villages). These municipal units are responsible for various local services, such as construction and maintenance of roads, bridges and parks, elementary and secondary education, social welfare, garbage collection and public health.

Between these local authorities and the central government are 47 prefectural governments, including 43 ken (prefectures) plus the administrative units for the metropolitan areas of Tokyo, Osaka and Kyoto and for the island of Hokkaido. This level of government handles intermunicipal public programs, like major highways and other transportation links, water supplies and high school education. The prefectural governments also coordinate municipal programs and mandates from the central government. Except for the Tokyo metropolitan government, which serves as a prefectural authority as well as a city authority for Tokyo's 23 districts, there are no differences in the functions performed by prefectural governments, even though some of the units go by different names.

The cabinet also has authorized several large cities, almost all of which have more than 1 million residents -- Sapporo, Sendai, Kawasaki, Yokohama, Nagoya, Kyoto, Osaka, Kobe, Hiroshima, Kitakyushu and Fukuoka, to perform some of the functions normally reserved for prefectural governments. Chiba will be added to this list in April 1992.

From the earliest days under the Meiji government, which engineered Japan's Western-style modernization through strong initiatives led by the central authority, local administrative units were regarded as the tools that could implement policy formulated by the national government, particularly the Ministry of Interior, which dealt with police, public works, health, welfare and local administrative affairs. This central-oriented structure mostly copied the German model, in which modernization was initiated under strong leadership from Berlin.

After World War II American occupation forces had a hand in revising the local government system. The new constitution ensured the autonomy of local governments. Governors, mayors and assembly members were to be elected by local

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residents. Plus, local assemblies received expanded authority to decide budgetary matters and local regulations as long as they did not run counter to national rules. The autonomy, however, was no more than superficial. To this day that has not changed. The central government continues to control many if not most local government activities by splitting certain national tax revenues with them, providing subsidies, mandating particular operations and drafting regional development programs; administrative guidance also plays a role.

Local Government Budget Authority

Revenues - The toughest challenge facing any local government today is finding enough money to provide the services residents expect. In FY 1989, the most recent fiscal year for which the books have been closed, taxes supplied 62.7 percent of the total revenues collected by local governments in Japan (see Table 1). The rest came from central government subsidies, local government

Table 1: Local Government Finance, FY 1989

(in billions of yen; settlement basis)

	Amount	Share
Revenues		
Local Tax Revenues	Y31,795	42.6%
Local Allocation Tax	13,455	18.0
Other National Tax Revenues Transferred to Local Treasuries	1,482	2.0
Subtotal	46,733	62.7
Grants from Central Government	10,377	13.9
Bonds	5,615	7.5
Other Revenues	11,843	15.9
Subtotal	27,835	37.3
Total	74,567	100.0
Expenditures		
Administrative Costs	9,309	12.8
Social Welfare	7,717	10.6
Health	4,102	5.6
Labor Affairs	460	0.6
Agriculture, Forestry and Fisheries	4,807	6.6
Commerce and Industry	3,055	4.2
Public Works	16,410	22.6
Fire	1,262	1.7
Police	2,436	3.3
Education	15,284	21.0
Debt Service	6,355	8.7
Other Expenditures	1,534	2.1
Total	72,729	100.0

Source: Ministry of Home Affairs, Chiho Zaisei Hakusho (White Paper on Local Government Finance), 1991.

borrowing and other sources, such as profits from lotteries or races. Revenues from taxes levied by local governments themselves represented two-thirds of the total tax take; the remainder came from national taxes, which the central government divvies up to help even out the discrepancy between local tax revenues in wealthier and poorer areas (see below).

In FY 1989 prefectural governments got 44.4 percent of their total tax revenues from what is known as the enterprise tax -- a tax on corporate or self-employment income. The prefectural inhabitants tax generated 29.4 percent of receipts; this tax is levied on residents' personal income or the capital of companies with offices there. In the same budget year municipal governments derived 54.4 percent of their tax revenues from the municipal inhabitants tax and 33.3 percent from property taxes.

The Local Tax Law and related implementing regulations determine basic tax rates and tax-exempt items. But local governments have some power to raise or lower tax rates. For example, municipal governments can increase personal income tax rates by up to 50 percent of the base level set by law; the comparable adjustment for companies is 20 percent.

In the year through March 1990 the central government transferred Y14.9 trillion ($110.6 billion at Y135=$1.00) in national tax revenues to local governments. This was equal to 23 percent of general account revenues that year. This revenue-sharing mechanism helps to compensate for differences that enable local governments in urban areas -- with their larger populations, higher real estate prices and more extensive business operations -- to raise more tax money than governments serving rural areas.

For example, if the average income of a Tokyo resident is equal to 1, then the incomes of urban residents of Osaka, Kanagawa and Aichi prefectures would rank at 0.76, 0.75 and 0.74, respectively. But residents in the countryside, such as those living in Okinawa, Kagoshima and Aomori prefectures, would have an average income of less than half that of their Tokyo counterparts, or 0.47, 0.48 and 0.48, respectively. Nationwide the average income works out to about 63 percent of a Tokyo resident's income.

Similarly, of the 100 largest firms in Japan (based on FY 1990 taxable income) 66 had their headquarters in Tokyo, 16 in Osaka and five in Aichi prefecture. Tokyo, Osaka, Aichi and Kanagawa prefectures, which together cover barely 3 percent of Japan's land area, had 28.5 percent of the nation's population in 1988. Moreover, they accounted for 35.1 percent of all sales of manufactured goods and 33.9 percent of total retail sales in 1987.

Income disparities by region tell a similar tale. Local tax revenues per person in the Kanto area, which includes Tokyo and six neighboring prefectures, was almost 45 percent higher than the national average in FY 1986 and three times greater than that of Okinawa prefecture (see Table 2).

The central government uses two means to distribute national tax revenues to local treasuries. The first, listed in the general account budget as the local allocation tax, funnels revenues from five taxes: the national personal income tax (32 percent of receipts), the national corporate income tax (32 percent), the liquor tax (32 percent), the tobacco tax (25 percent) and the consumption tax (24 percent). If the monies transferred under this formula are

Table 2: Comparison of Local Government Revenues per Resident by Region, FY 1986

(100 = nationwide average)

Region	Total Revenues*	Local Taxes (A)	Local Allocation Tax (B)	Subsidies (C)	A+B	A+B+C
Hokkaido	129.0	68.9	181.3	161.9	104.7	121.2
Tohoku	124.1	65.8	199.5	154.3	108.4	121.7
Kanto	91.6	144.6	36.1	62.9	110.0	96.4
Chubu	76.9	100.4	58.7	84.0	87.1	86.2
Hokuriku	131.7	90.2	182.6	144.8	119.7	126.9
Kinki	85.7	94.4	52.9	69.8	81.2	77.9
Chugoku	113.7	73.0	158.2	137.7	100.2	111.0
Shikoku	127.8	63.8	223.3	143.3	114.6	122.9
Kyushu	107.5	59.7	174.7	139.1	96.3	108.7
Okinawa	121.3	46.7	220.6	206.4	102.1	132.2
Nationwide	100.0	100.0	100.0	100.0	100.0	100.0

*Includes revenues other than those listed, such as bond issues.

Source: Chiho Zaisei Kyokai (Association of Local Government Finance)

added to local tax revenues, the maximum regional difference in tax revenues per capita narrowed to 19 percent of the national average in FY 1986.

The other transfer of national tax revenues to local governments falls under the special-purpose category. For example, the proceeds from the gasoline tax are distributed to prefectural governments in accordance with the extent of national and prefectural highways within their jurisdictions and the need to maintain and extend these roads. Likewise, receipts from the motor vehicle tonnage tax, paid by people owning cars or trucks, is allocated to municipal governments for maintenance and construction of municipal roads. Revenue from the aviation fuel tax is allocated to prefectural and municipal governments with airports within their boundaries so they can fund measures to counter noise caused by take-offs and landings.

Expenditures - Apart from administrative and debt-servicing costs, local governments spend most of their money on public works, education, social welfare and support for primary industry (Table 1). The central government underwrites a portion of these program costs through grants (see Table 3). In FY 1989, for example, the Ministry of Agriculture, Forestry and Fisheries helped to finance programs that represented 75 percent of what was done at the prefectural and municipal level to assist farmers, loggers and fishermen. Similarly, Ministry of Construction grants provided partial funding for almost two-thirds of the cost of housing projects undertaken by local governments, about two-fifths of their erosion and flood control work, approximately one-third of city planning programs and nearly a third of road and bridge maintenance and construction work. In addition, the Ministry of Education split 29 percent of the cost of public education.

Table 3: Local Government Programs by Funding Source, FY 1989

	Local Programs Partly Funded by Central Government	Local Programs Fully Funded by Local Governments	National Programs Partly Funded by Local Governments	Total
	(in billions of yen)			
Agriculture, Forestry and Fisheries	Y2,429	Y679	Y147	Y3,256
Construction	4,804	5,861	897	11,563
Roads and Bridges	1,412	2,617	505	4,534
Erosion and Flood Control	1,290	537	296	2,124
City Planning	1,125	2,264	6	3,395
Housing	574	294	0	868
Education	750	1,861	0	2,612
Other Programs	489	2,509	0	2,999
Total	8,472	10,912	1,045	20,428
	(share)			
Agriculture, Forestry and Fisheries	74.6%	20.9%	4.5%	100.0%
Construction	41.5	50.7	7.8	100.0
Roads and Bridges	31.1	57.7	11.1	100.0
Erosion and Flood Control	60.7	25.3	14.0	100.0
City Planning	33.1	66.7	0.2	100.0
Housing	66.1	33.9	0.0	100.0
Education	28.7	71.2	0.0	100.0
Other Programs	16.3	83.7	0.0	100.0
Total	41.5	53.4	5.1	100.0

Source: Ministry of Home Affairs, Chiho Zaisei Hakusho (White Paper on Local Government Finance), 1991.

Some national programs, like construction of national highways and erosion and flood control work, require local entities that benefit from the projects to share part of the costs. Local government budgets show these expenditures as transfers to the central government. In reality, however, the direction in which public-sector money flows matters less than that programs at both the national and the local level are financed through a combination of central, prefectural and municipal money. The cabinet decides the cost-sharing formula for various programs and projects in each fiscal year's budget plan. In FY 1991, for example, the central government paid 60 percent of the cost of each national erosion and flood control program and 55 percent of the cost of each similar local government project; the rest of the money for both types of work came from local government budgets.

Since grants from Tokyo are an indispensable part of local governments' finances, especially in rural areas, cultivating good relations with the central government's bureaucracy is one of the most time-consuming aspects of the job for prefectural and municipal administrators. Effective local government officials make frequent visits to the branch offices or even the headquarters of ministries and agencies that control revenue-sharing funds to improve their chances of winning money that is not distributed by formula. They also try to enlist the help of their area's Diet members. Districts represented by powerful politicians in the ruling Liberal Democratic Party reportedly tend to receive more money than others, especially for construction projects, such as national highways and high-speed train lines.

Given the general tendency of government units in rural areas to depend heavily on grants from Tokyo plus the underrepresentation of urban areas in the Diet, the populous Kanto or Kinki regions get just one-third to one-half of the subsidies on a per-capita basis that go to other regions; the Chubu region is the other exception. Furthermore, total per-resident revenues (including local tax revenues, the local allocation tax, grants and other funds) in such rural areas as Hokuriku and Hokkaido exceed the figure for urban areas like Kanto, Chubu and Kinki (see Map and Table 2).

Several analysts say that people who live in Osaka, Kobe, Kyoto and other parts of Kinki have only themselves to blame for the region's relatively small share of the federal pie. In the conventional wisdom, at least, Kinki residents traditionally have been adverse to depending on Tokyo for a significant share of their local governments' money. More important perhaps, a number of city and town governments there are headed by members of the Socialist Party of Japan or other opposition parties. In addition, the bureaucracy in Tokyo is not disposed toward channeling money to areas where local officials earn a lot more than they do and that includes a good part of the Kinki region. With average government salaries 12.8 percent higher than the central government figure in 1990, Sakai, Osaka prefecture, was at the top of the list of cities with high-paid officials; the next eight places on the list also were occupied by cities in Osaka prefecture.

Importance of Local Government Spending

Because of revenue-sharing local government expenditures are much bigger than central government outlays. (The same is true in the United States.) In FY 1989, for example, 62 percent of the Y116.3 trillion ($861.5 billion) spent by the public sector went through prefectural and municipal government budgets (see Table 4). In particular, local governments ended up paying 88 percent of the costs of public education, 80 percent of the expenses connected with land conservation and disaster work and 56 percent of social welfare costs.

Gross national product statistics for the April 1989-March 1990 period underscore the importance of local governments in both public-sector current expenditures and fixed investment -- two areas of major concern to Washington in the SII talks. Local governments accounted for 75 percent of the nearly Y36 trillion ($266.5 billion) in nominal terms that the public sector spent on goods and services. Similarly, nominal fixed investment by prefectures and municipalities represented 77 percent of the Y26.4 trillion ($195.3 billion) the central and local governments devoted to capital formation in FY 1989.

Prefectures of Japan

Table 4: Total Expenditures by Central and Local Governments, FY 1989

(in billions of yen; settlement basis)

	Central Government	Local Government	Total	Local Government Share
Administrative Costs	Y2,858	Y13,845	Y16,703	82.9%
Defense	3,920	0	3,920	0.0
Land Conservation and Disaster Work	4,359	17,654	22,012	80.2
Support for Agriculture, Commerce and Industry	4,359	4,584	8,943	51.3
Education	2,076	15,177	17,253	88.0
Social Welfare	11,124	13,853	24,977	55.5
Debt Service	12,090	6,355	18,445	34.5
Other Expenditures	3,864	190	4,054	4.7
Total	44,649	71,658	116,307	61.6

Note: The total for local government expenditures differs from that listed in Table 1 mainly because central government programs partly funded by local governments are counted as local government expenditures in Table 1 but as central government expenditures in this table. Subsidies from the central government to local governments are treated as local government expenditures in both tables. Administrative costs in this table include outlays for police and fire; these expenses are listed separately in Table 1. Similarly, expenditures for health, labor affairs and part of public works spending, such as housing, are included here as social welfare expenditures.

Source: Ministry of Home Affairs, Chiho Zaisei Hakusho (White Paper on Local Government Finance), 1991.

Problems in Regional Development

Despite the significant amount of money spent year after year by local governments, particularly in rural areas, the economic situation outside Japan's urban areas has not improved substantially. Population continues to flow from rural areas to cities in spite of the problems associated with metropolitan life, such as the high cost of housing and overcrowded transportation systems.

Urbanization also has accelerated because of the younger generation's tendency to study in metropolitan areas and then find jobs there. A survey by the Ministry of Education showed that from 1989's graduating college class of 300,019 students, 97,489 were graduated from schools in Tokyo, 27,049 in Osaka, 19,803 in Kanagawa prefecture, 19,281 in Aichi prefecture and 18,348 in Kyoto. Not only did more than 60 percent of the students graduate from universities in urbanized areas but most of them were recruited by companies that also were located in major cities. Only about 30 percent of the graduates of universities in other prefectures continued to work in the same prefectures where they go to

school. This points to both a relatively small number of universities in non-metropolitan prefectures and a scarcity of job opportunities for highly educated students in these areas.

Prefectural governments in rural and semiurban areas generally devote considerable time and money to attracting new businesses. These efforts are designed to provide job opportunities so the younger generation will not move away and to increase the tax base. The current relationship between local governments and the central government, however, sometimes tends to blunt the effectiveness of these initiatives. Prefectures and municipalities not only look to Tokyo to fund part of the cost of their business promotion programs but they also are dependent on the central government for much of the money needed to improve their industrial infrastructure, such as transportation links, and to provide the services that will attract new business. In short, local governments trying to implement major industrial development programs often find themselves at the mercy of central authorities.

Although Tokyo heralded its FY 1988-FY 1989 furusato (hometown) program, in which each prefecture and municipality received a Y100 million ($740,700) grant to carry out whatever programs it desired, central government officials always have exhibited more interest in local industrial development programs that they design and manage than in those initiated by the prefectures. These central government programs include the new industrialized cities project undertaken in the 1960s to relocate heavy industry away from metropolitan areas and the Ministry of International Trade and Industry's ongoing technopolis program, aimed at developing a series of high technology-oriented zones. Likewise, highway, railroad and air transportation development programs focus mainly on improving local areas' access to Tokyo-or other metropolitan areas rather than on building up intraprefectural transportation networks.

Some critics argue that central government-designed development programs, oriented as they are to business centers, have discouraged local community leaders from taking the initiative in drafting their own development projects. The more that local governments in rural and semiurban areas depend on the central government, the more that residents and businesses in these places will tend to move to Tokyo, these critics say.

Administrative Reform Tackles Decentralization

Growing calls from prefectural and municipal officials as well as business leaders for greater local government autonomy have put the relationship between the central and local governments on the agenda of a series of administrative reform panels created by recent prime ministers. Since 1981 these groups have issued a dozen reports; 10 have referred to local government issues.

A December 1989 report dealt most comprehensively with relations between the central and local governments. The panel proposed that local government finances be made less dependent on federal largesse. Among the suggested options were: a review of the local allocation tax system and its distribution, more flexibility for local entities to issue bonds, and reduced subsidies from the central government. At the same time the panel suggested that local governments make their own operations more efficient; that would reduce their dependence on central government funding. Privatization of public corporations was recommended in this context.

The report also urged Tokyo to reduce as much as possible its use of administrative guidance to influence the activities of local governments. A similar recommendation was made concerning regulatory control of matters that really are local government decisions. To cite just one example, local governments have to obtain clearance from the Ministry of Transportation before they can change bus routes. At the same time the advisory panel proposed a review of local government functions mandated by Tokyo, such as licensing and registration, to see if duplication can be eliminated when there is overlapping jurisdiction. Not only do both levels of government regulate the opening of supermarkets, department stores and other big retail outlets under the Large Retail Store Law as well as the contruction of factories, but each also has a say on such matters as whether a barbershop or a dry cleaner can go into business and if a hotel, school or hospital can be built.

In the most recent report, issued this past July, the administrative reform group focused on improving the standard of living in Japan by, among other measures, transferring some central government functions to local entities, reducing gaps in the economic and social development of metropolitan centers and rural or semiurban areas, and resolving urbanization problems, including the high cost of housing. The report stressed the necessity of breaking down Japan's central-oriented administrative system and establishing autonomous local governments to cope with current social and economic problems.

Following up on the recommendations contained in the December 1989 report, several concrete measures were outlined to give prefectures and municipalities more freedom to handle local affairs. For example, the report suggested that local governments have independent sources of revenue to fund such services as social welfare, education and cultural activities. Community members should have input in city planning decisions and the design of local industry promotion programs, the report said. It also urged local governments to establish community colleges and provide other educational programs to keep the younger generation interested in staying and studying in their home community. Other proposals included creation of transportation and information links between core local cities, which, the report said, should be encouraged more than networks between Tokyo and local cities. In line with calls to shift many central government functions to the local level, panel members said the preferred system is a small, efficient central government with responsibilities limited to such areas as defense and diplomacy.

Although both the 1989 and the 1991 reports emphasized the need to review the current structure of local government as part of the process of examining the transfer of central government functions to prefectures and municipalities, neither advisory panel spelled out what type of local government unit would be best-suited to handling additional responsibilities. Some local business organizations and think tanks have suggested that prefectural governments in such areas as Kanto, Chubu and Tohoku be replaced by regional governing bodies. Another proposal is to meld cities and neighboring towns into larger municipal units, each of which would have a population of around 300,000.

A much talked-about plan being studied by the government, the Diet and the private sector involves relocating the national capital and its administrative functions. Common to all these studies is the basic concept of replacing the current centrally oriented administrative system with a decentralized, locally oriented system of government.

Improving the Business Atmosphere for Foreigners

Many of the suggested administrative reforms also would be beneficial to foreign companies eyeing or operating in the Japanese market. Transferring regulatory power to prefectures and municipalities would streamline the approval process and other administrative procedures that firms must navigate to do business in Japan. Thus, business deregulation would be accelerated through decentralization. In addition, putting more regulatory power in the hands of local officials might persuade companies that they do not have to maintain offices in Tokyo to operate efficiently; that would trim costs.

Shifting more government functions to the local level also might foster the expansion of the economic infrastructure in nonmetropolitan areas. If, in addition, local governments had greater flexibility to offer incentive packages to potential investors, companies, including foreign firms, would have more options on where to locate their offices, factories and other facilities. Locating outside Tokyo and other metropolitan areas provides businesses savings beyond those associated with the cost of owning or leasing space; labor costs, for example, generally are lower in nonurban areas.

Outlook

The tradition of a centrally oriented government system, including the dependence of prefectures and municipalities on Tokyo for money, will not be easy to change over the short run. Opposition to decentralization still runs strong in certain quarters, especially among central government officials who exercise considerable authority over local government affairs. But interest in change is mounting in at least one part of the central government, the Ministry of Finance.

With national personal and corporate income tax revenues running behind projections in the current fiscal year (see JEI Report No. 41B, November 1, 1991), MOF budget officials have started to review the revenue-sharing system. They reportedly are considering a substantial cut in the amount of money transferred to local governments beginning in FY 1992. Under study is a reduction in the percentage of national tax revenues automatically transferred to prefectures and municipalities via the local allocation tax; subsidy programs also are being examined.

Increasing the chances that something, however modest, will be done in the upcoming fiscal year is the projection of higher FY 1992 local government revenues. Real estate taxes, in particular, are expected to be up because property values, last appraised for tax purposes in 1988, were reassessed this year. But cutting back on revenue-sharing is unlikely to be a cost-free move for Tokyo. No doubt it will have to give local governments more power.

Shifting power to local governments could lead to more fragmented administration and regulation, as happens in the decentralized United States. On balance, though, decentralization, very much a domestic issue, should result in a more open business climate for foreign firms in Japan.

For further information, contact Tadashi Saito.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.